

NONBANK ACTIVITIES OF FIFTH DISTRICT BANK HOLDING COMPANIES*

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The 1970 amendments to the Bank Holding Company Act, which brought one-bank holding companies under the regulation of the Federal Reserve System, provided stimulus for the formation of new bank holding companies, for the acquisition of independent commercial banks by these corporations, and for the expansion by holding companies into nonbank activities permitted under Federal regulation. At the time of enactment of the amendments, 111 registered bank holding companies controlled 6.6 percent of insured commercial banks and 16.1 percent of bank deposits in the United States. By the end of 1978, 2,113 holding companies controlled 27.9 percent of all domestic banks and 67 percent of bank deposits.¹ Liberalization of the criteria for permitting nonbank activities in 1970 also produced an expansion in bank holding company investment in nonbank subsidiaries. It has been estimated that these companies control nonbank firms with combined assets of \$50 to \$55 billion, approximately five percent of the total assets of the commercial banking system [11].

Research on the holding company movement has, until recently, concentrated on the impact it has had on bank performance, bank safety and soundness, and competition in banking markets. Also of interest is the performance of nonbank subsidiaries and their effect on the consolidated firm. Analysis of this question, unfortunately, has been hampered by data limitations. Recently, however, attention has been devoted to the financial performance of nonbank affiliates. After summarizing some of the findings of this recent research, this article will briefly examine the economic rationale for bank holding company diversification. Finally, it will report on investment by Fifth District firms in subsidiaries engaged in nonbanking activities and on the recent relative profit performances of nonbank affiliates.

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¹ Annual Statistical Digest and internal records, Board of Governors of the Federal Reserve System.

Nonbank Activities and Performance The Board of Governors of the Federal Reserve System has authority to allow holding companies to own shares in any company engaged in activities the Board has determined to be "so closely related to banking or managing or controlling banks as to be a proper incident thereto."² In exercising its authority, the Board has created a list of approved activities.³ To a large degree, approved activities are limited to those that national banks are permitted to engage in directly. The only activities on the list prohibited to national banks are industrial banking and underwriting credit life, accident, and health insurance. Bank holding companies, however, have concentrated their investment in relatively few of these nonbanking activities. Investment in nonbank lending operations (finance companies, mortgage banking, leasing and factoring) has been particularly widespread. In addition, many companies own subsidiaries engaged in credit insurance activities and firms that provide internal services for the holding company and its affiliates, such as data processing. A glossary of nonbank activities engaged in most frequently by banking organizations accompanies this article.

Several recent studies have evaluated the financial impact of selected nonbank activities on the parent corporation. In general, their findings suggest that returns to holding companies from these operations have not matched returns experienced by non-affiliated firms. These conclusions are based upon comparisons of the performance of nonbank subsidiaries with independent companies in the respective industries or with industry averages.⁴ Talley [13],

² In determining whether a particular activity is a proper incident to banking, the Board must consider whether its performance by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. Bank Holding Company Act, Section 4(c)(8).

³ Regulation Y, Section 225.4(a) (12 CFR 225).

⁴ For a review of this literature, see [2].

Boczar and Rhoades [1], and Rice [7] examined the relative performance of affiliated finance companies during 1973-76 and found them less profitable than independent firms. Finance company subsidiaries experienced an average rate of return on equity investment of 4.7 percent over the 1974-76 period while the industry averaged a 9.3 percent yield over this period. In addition, holding company subsidiaries were found to be more highly leveraged, more dependent on short-term financing, and more likely to have a higher cost of funds than their independent counterparts. Profitability of finance company affiliates appeared to improve significantly in 1976 and 1977 but it still trailed the industry as a whole [9].

Bank holding company mortgage affiliates were also found to be less profitable than independent companies and the mortgage industry in general. The severity of the 1973-75 recession in the real estate sector of the economy and its repercussions on mortgage lenders caused mortgage affiliates to suffer average net losses of 2.4 percent of equity per year over the 1974-76 period while the industry averaged losses of only 1.6 percent [9, 13]. Analysis of the equipment leasing area shows that holding company subsidiaries outperformed the finance company and mortgage affiliates of holding companies during 1974-76, yet they still trailed the leasing industry average. Leasing subsidiaries averaged an 8.5 percent return on equity while the industry average was 9.9 percent [9]. Insurance activities, on the other hand, have apparently been quite profitable for bank holding companies. Rice [8] found that affiliates engaged in insurance underwriting averaged nearly 30 percent return on equity investment in 1976 and 1977.

In addition to comparing bank holding company affiliate performance with independent companies within respective industries, Rice [9] analyzed total industry profit returns for banking and for five of the leading nonbank activities (consumer finance, sales finance, mortgage banking, leasing, and life insurance) engaged in by bank holding companies from 1970-76 and found that banking had the highest return on equity, with an average of 11.1 percent. The consumer finance industry realized a 10.1 percent yield, followed by 9.9 percent for equipment leasing, 9.8 percent for sales finance, 9.3 percent for life insurance, and 7.7 percent for mortgage banking. Nonbank affiliates of holding companies apparently did not perform as well (relative to banking) as the industry averages suggest.⁵ For

⁵ As Rice points out [9], the relative industry performances may not accurately reflect bank holding company performance since their involvement in some of these activities is restricted or altered by Regulation Y.

the years 1976 and 1977, return on equity to parent holding companies from consolidated investments in nonbank companies were only slightly greater than half the average return from their bank subsidiaries (6.3 percent compared with over 11 percent). Rice also categorized affiliates into financing and nonfinancing subsidiaries.⁶ The returns on equity investment from financing and nonfinancing subsidiaries were 5.0 percent and 26.6 percent, respectively. Moreover, the nonbank activities of companies with less than \$500 million in assets were more profitable than for larger holding companies, apparently because these firms held a larger proportionate investment in nonfinancing activities.

In summary, available empirical evidence concludes that bank holding company profit performance in major permissible nonbank activities has not, in general, matched industry standards. In addition, average returns to equity from nonbank operations have been found to be significantly below returns from bank affiliates. What then is the economic benefit or justification for holding company expansion into nonbank activities?

Economic Rationale It has been suggested that if "all parent resources invested in nonbank subsidiaries were instead invested in bank subsidiaries . . . , the BHC's aggregate income could have been increased" substantially.⁷ If this statement were true, however, one might infer that bank holding company managements were (1) incompetent, (2) not interested in profit maximization, (3) prohibited from expanding their bank operations, or (4) positioning for interstate banking. Each of these inferences, however, has major weaknesses and none provides a fully satisfactory explanation of observed behavior. Since economic theory suggests that firms benefit from diversification if the total profits of the firm are increased or if the firm's perceived risk exposure is reduced, further examination is required.

Increased Profits Traditional price theory suggests that the optimal quantity of output of a firm is determined by its marginal revenue and marginal cost conditions. A profit-maximizing firm will tend to

⁶ Financing affiliates were defined to consist of finance companies, mortgage bankers, leasing companies, and factors. Nonfinancing subsidiaries were insurance underwriters and agencies, management consulting firms, and advisory companies.

⁷ This conclusion is based on the assumption that bank subsidiaries could provide the same (average) return on the additional (marginal) investments [9].

invest additional resources in any activity up to the point where the last resource unit just pays for itself, i.e., where the marginal revenue derived from that activity is equal to the marginal cost of production ($MR=MC$).

It can be argued, of course, that required reserve ratios and limitations on the aggregate volume of bank reserves restrict a bank's ability to increase output to the point where marginal revenue equals marginal cost [14]. The prohibition on the explicit payment of interest on demand deposits together with interest rate ceilings on other small deposit categories virtually guarantees that the interest on bank loans and investments (marginal revenue) will exceed the marginal cost of such funds, at least in today's high interest rate environment. In addition, excess reserves held by member banks must be held in the form of nonearning assets. Banks, therefore, are usually eager to invest any excess reserves they may hold. There is not an unlimited supply of low cost funds, however. In fact, the trend appears to be toward a drying up of these sources. To an increasing degree, banks have been forced to rely on funds purchased at market rates of interest to finance expanded lending and investments. The marginal revenue - marginal cost analysis, therefore, does appear to be applicable to the banking firm.

Suppose that a bank produces at its profit-maximizing level and earns an average return on equity of 15 percent. The last (marginal) unit of banking services produced, however, brings in revenue that just covers its cost so that the marginal yield is zero. Investment beyond this point will actually reduce total profits since the cost of producing additional units will exceed additional revenues ($MC > MR$). An expansion-minded firm may then face a choice between producing more banking services or offering other services through a nonbank subsidiary (with, say, a ten percent marginal return on investment). Which investment should the firm make? In this example, it is clear the firm should diversify through the nonbank subsidiary. Investment in the nonbank subsidiary increases total profits and the investment yields a higher average rate of return for the total firm than does expanding the banking operations. If the existing investment in banking totaled \$1000 and an additional \$100 investment is contemplated with returns in banking and nonbanking of zero and ten percent, respectively, then the computations in Table I show that the marginal investment in the nonbank activity is the more profitable alternative. The total profit (π) equation is:

$$\pi = \sum_{i=1}^n W_i R_i$$

where W_i is the dollar investment in the i^{th} activity and R_i is the activity's average rate of return on investment.

Table I

	<u>Total Profits</u>	<u>Average Profits</u>
Alternative A		
Banking Alone		
	$[(1000 \times .15) + (100 \times .0)] = 150$	13.6% $\left(\frac{150}{1100} \right)$
Alternative B		
Banking & Nonbanking		
	$[(1000 \times .15) + (100 \times .10)] = 160$	14.5% $\left(\frac{160}{1100} \right)$

Generalizing, for the investment to favor the nonbank subsidiary, it is only necessary for the return on the marginal investment in the bank to be less than for the nonbank activity. The determining factor, therefore, is how much the additional or marginal investment adds to the profits of the consolidated firm. Average rates of return on prior investments can give misleading signals for management investment decisions.⁸

The decision to engage in nonbank activities might also be described by a model that represents the company as a multiple-product, price-discriminating firm [12]. In this model, the firm maximizes profit by segmenting markets—credit markets in the special case of a banking firm—with distinguishable demand characteristics and setting different prices in each market in order that the marginal revenues in each market are equal. This behavior may involve limiting production in the most profitable product markets and engaging in some marginally profitable activities.

Reduced Risk Theory also suggests that diversification into nonbank activities may reduce risk by reducing the variability of the consolidated firm's profits. This could result from either of two sources: (1) product-line diversification, or (2) geographic diversification. Diversification of the firm's product line may reduce holding company risk if nonbank profits do not vary directly with bank profits. Correlation coefficients can measure the degree to which bank profits and nonbank profits move together from year to year. Other things equal, the lower the

⁸ One major domestic bank failure was apparently due, at least in part, to bank management confusing the concepts of average and marginal returns [10].

degree of correlation between bank and nonbank profits, the lower will be the variability (standard deviation) of holding company profits.⁹

A number of recent studies have reported correlation coefficients between banking profits and returns in nonbank activities most popular with bank holding companies [3, 4, 5, 9]. These studies have generally indicated that nonbank profits were not highly correlated with bank profits and that several were negatively correlated, thus implying potential benefits of product-line diversification.¹⁰ According to these studies, therefore, some nonbank activities may actually enhance the stability of the consolidated firm's profit stream.

Bank holding company risk may also be reduced through a greater geographic diversification attainable via nonbank affiliates. As noted earlier, most permissible activities can be engaged in directly by commercial banks. Bank operations, however, are limited geographically by state and Federal branching statutes. A nonbank affiliate is not so restricted and is free to expand its geographic base subject to regulatory approval. To the extent geographic diversification insulates company profits from localized economic conditions and contributes to profit stability, firm risk may be reduced. Little evidence is presently available on the contribution (if any) of geographic diversification to reducing risk, however.

Fifth District Performance Thirty-seven Fifth District bank holding companies with total assets of \$45 billion reported \$2.2 billion of nonbank assets as of year-end 1977.¹¹ This figure, representing five

⁹ The standard deviation (s) of holding company profits will be:

$$s = \left[\sum_{i=1}^n w_i^2 \sigma_i^2 + 2 \sum_{i=1}^n \sum_{j=1}^n w_i w_j c_{ij} \sigma_i \sigma_j \right]^{1/2}$$

where w_i is the proportion of capital invested in the i^{th} activity, σ_i is the standard deviation of profits in the i^{th} activity, and c_{ij} is the correlation between profits in the i^{th} and j^{th} activities. Since bank activities constitute the predominant investment of BHCs (i.e., they have the largest w_i), the correlation between banking and other activities will dominate the right hand portion of the above equation.

¹⁰ Mortgage banking showed the highest correlation with banking while life insurance and equipment leasing were negatively correlated and consumer finance was uncorrelated [9].

¹¹ These BHCs were located in the District of Columbia, Maryland, North Carolina, South Carolina, and Virginia. A total of 55 bank holding companies controlling nearly \$55 billion in total assets are registered in the Fifth Federal Reserve District. Some of these, however, are themselves subsidiaries of holding companies. Their inclusion in the analysis, therefore, would result in double counting of assets. A few small "grandfathered" West Virginia bank holding companies were also excluded

percent of total assets, understates the importance of nonbank operations to some individual firms, however. The nonbank proportion of assets ranged up to 12.6 percent for one of the larger holding companies in the District. On the other hand, four smaller companies held no nonbank assets at all. Size apparently had little to do with participation in nonbank activities, however. Nineteen holding companies, ranging in size from \$1.0 billion to over \$4.5 billion in assets, held virtually the same proportion of total assets in nonbank firms as did the smaller firms. Nine of the firms held more than six percent of total assets in nonbank subsidiaries while only two held nonbank assets that represented more than ten percent of consolidated assets. In terms of capital investment, nonbank operations account for a more substantial share of bank holding company activities. Nonbank equity investment represented 8.4 percent of the firms' total equity capital.

Table II shows the number of holding companies owning subsidiaries involved in nonbank activities along with the proportions of consolidated assets and total nonbank assets accounted for by each activity. More Fifth District bank holding companies are active in mortgage banking than in any other nonbank activity. Twenty-five companies own mortgage subsidiaries holding 1.45 percent of total company assets and nearly thirty percent of total nonbank assets. Consumer finance, leasing, and factoring companies

from the analysis since state law has prohibited holding company expansion in the state. These are primarily industrial firms that acquired small banking operations and therefore, differ significantly from other holding companies within the District. All nonbank financial data were derived from Bank Holding Company Annual Reports filed with the Federal Reserve System.

Table II

NONBANK ACTIVITY OF FIFTH DISTRICT BHCs

	Number of BHCs Active	Percent of Total BHC Assets in Activity	Percent of Nonbank Assets in Activity
BHCs	37	100	—
Bank Subsidiaries	37	95.1	—
Mortgage Banking	25	1.45	29.7
Consumer Finance	16	.88	18.0
Sales Finance	5	.27	5.5
Commercial Finance	5	.27	5.5
Leasing	21	.53	10.9
Factoring	4	.60	12.3
Insurance	19	.18	3.7
Data Processing	16	.10	2.1
Other	—	.60	12.3

also accounted for significant shares of total nonbank assets, although each activity represented less than one percent of total bank holding company assets. A number of companies also own active subsidiaries engaged in consumer finance, leasing, insurance, and data processing—although the latter two activities do not represent a substantial share of nonbank assets. The dominance of subsidiaries engaged in extending credit is demonstrated by the aggregate 81.9 percent proportion of total nonbank assets held by mortgage, finance company, leasing, and factoring subsidiaries.

Analysis of the profitability of bank holding company subsidiaries in the Fifth District supports the conclusions of previous studies. Compared with bank affiliates, the financing subsidiaries reported lower rates of return on equity investment while nonfinancing affiliates reported higher rates of return. Table III shows the average returns on assets and equity capital, as well as the equity to assets ratios for each activity over the 1975-78 period. The non-weighted average return on equity of financing affiliates was 6.46 percent over the entire period compared with slightly over twelve percent for the bank affiliates of holding companies. Within this category, mortgage subsidiaries reported the lowest returns with an average return on equity investment of 2.55 percent. Sales finance, factoring, and leasing were the most profitable of the financing affiliates but each was outperformed by the commercial banks. Subsidiaries involved in insurance activities, on the other hand, constituted the single most profitable activity, realizing an average annual return on equity of over sixty percent. Data processing activities yielded only 7.3 percent return on investment but most of these affiliates simply provide computer support for the corporation itself and are intended as little more than break-even operations. The few subsidiaries within the District that were engaged principally in providing data processing services to the general public, in contrast, averaged a robust 42 percent return on equity over the period.

The nonbank affiliates realized substantially higher net returns on total assets than did the banks. This is in marked contrast with results obtained when relative profits are measured by return on equity. Banking, at .84 percent, was the only activity that averaged less than one percent return on assets. Nonbank returns ranged from 1.2 percent for mortgage banking and leasing to over four percent for consumer finance affiliates and over twenty percent for insurance subsidiaries.

The apparently contradictory profit ratios reflect the high degree of leveraging evident in bank oper-

Table III
**RETURN ON ASSETS AND EQUITY CAPITAL,
AND EQUITY TO ASSETS RATIOS
BANK AND NONBANK SUBSIDIARIES
1975-1978**

	Net Income/ Assets (%)	Net Income/ Equity Capital (%)	Equity/Assets (%)
Bank Subsidiaries	.84	12.06	6.9
Mortgage Banking	1.20	2.55	19.7
Consumer Finance	4.26	7.84	29.4
Sales Finance	3.07	10.84	18.3
Commercial Finance	1.63	6.34	12.3
Leasing	1.20	8.62	21.3
Factoring	3.49	8.71	23.6
Insurance	20.88	63.53	47.2
Data Processing	2.10	7.29	58.4

ations relative to nonbank activities. Banks fund a much larger proportion of assets with borrowed funds (deposits) while nonbank subsidiaries rely more on capital injected from the parent corporation. If nonbank subsidiaries were leveraged to the same degree as their affiliate banks, returns on equity might be higher.¹² Banks have a distinct advantage over nonbank affiliates in their access to a stable, dependable deposit base. It is difficult to know, therefore, whether return on assets or return on equity is the most appropriate profit measure when comparing affiliates.

Table III also gives the average equity capital to total assets ratios for bank and nonbank activities of Fifth District companies over the 1975-78 period. The bank ratio averages only 6.9 percent, considerably lower than that of any other activity. The financing affiliates generally had from two to four times as much equity per asset dollar as the banks, while the nonfinancing affiliates' ratios were even higher.

Table IV reports the average rates of return for the holding companies, bank, and nonbank subsidiaries, respectively, for each year. The earning trend of the holding companies was dominated by the continual improvement in profitability of their bank affiliates following the 1974-75 recession. The recession affected mortgage affiliates most harshly. The average returns on equity were negative in 1975 and 1976. The especially poor average performance in these years is dominated by severe losses realized by

¹² Evidence from consumer finance and mortgage affiliates [1, 13], however, suggest a movement toward greater leveraging was not successful in improving profitability.

Table IV

**RETURN ON ASSETS AND EQUITY CAPITAL
BHC, BANK, AND NONBANK SUBSIDIARIES
(By Year)¹**

	Net Income/Assets (%)				Net Income/Equity Capital (%)			
	1975	1976	1977	1978	1975	1976	1977	1978
BHCs	.74	.77	.81	.86	10.42	11.84	12.77	13.72
Banks	.79	.81	.83	.89	11.46	11.38	12.01	13.17
Mortgage Banking	.00	1.32	1.33	1.90	-3.51	-1.38	2.70	6.91
Consumer Finance	1.18	1.26	9.75	4.76	4.29	4.65	11.58	13.68
Sales Finance	.44	1.15	4.80	1.32	3.21	7.90	16.33	5.42
Commercial Finance	.62	-.14	1.89	4.08	5.43	-14.68	22.74	14.82
Leasing	.95	1.79	1.05	1.13	11.05	2.24	12.41	6.36
Factoring	.35	11.13	3.82	-1.34	2.62	25.15	13.74	-6.68
Insurance	11.00	24.30	24.60	21.53	25.22	84.25	55.60	83.11
Data Processing	9.63	6.82	-7.80	2.30	19.01	15.14	-7.80	10.16

¹ Reported ratios represent the average of all BHCs, banks, and nonbank subsidiaries in 1975, 1976, 1977, and 1978, respectively.

a few companies.¹³ Profits of Fifth District mortgage affiliates improved significantly in 1977 and 1978 but remained far behind the banks in terms of return on investment. Consumer finance companies, with return on equity less than half that of the banks in 1975 and 1976, showed considerable income growth, attaining virtual parity with the banks in 1977 and 1978. Insurance affiliates consistently turned in the highest rates of return and were apparently not adversely affected by the recession. Leasing and data processing show no discernible trend although both performed relatively well during the recession. No trend is evident for sales and commercial finance or factoring subsidiaries. The small number of companies in these activities within the District cautions against drawing inferences from their profit performance.

With the single exception of insurance affiliates, therefore, investment in nonbank subsidiaries were less profitable than bank activities for Fifth District holding companies, using return on equity as the criteria. Alternatively, when return on assets is employed as the profit measure, nonbank operations were apparently more profitable than banking.

The profit ratios also provide some insight on whether product-line diversification contributed to stabilizing profit streams of bank holding companies. Correlation coefficients were computed between rates of return for banking and each nonbanking activity

of Fifth District firms over the 1975-78 period. Tentative results (see Table V) suggest that diversification benefits may be difficult to realize in mortgage banking, consumer finance, and commercial finance, since these activities demonstrated relatively high positive correlations with banking. This is not too surprising, however, since banks directly engage in mortgage, consumer, and commercial lending to major degrees. Insurance activities of Fifth District companies were also positively correlated with banking. This evidence runs counter to previous findings that life insurance industry returns were negatively correlated with banking returns. It should be remembered, however, that bank holding company insurance activities are restricted by regulation. The profit experience of insurance affiliates, therefore, may differ from the rest of the industry. It also

Table V

**CORRELATION COEFFICIENTS BETWEEN BANK
AND NONBANK RATES OF RETURN**

	Correlation with Banking	
	Income/Assets	Income to Equity
Banking	1.000	1.000
Mortgage Banking	.839	.950
Consumer Finance	.408	.906
Sales Finance	.153	-.020
Commercial Finance	.931	.590
Leasing	-.122	.004
Factoring	-.442	-.728
Insurance	.442	.444
Data Processing	-.387	-.273

¹³ These losses were over fifty percent of equity per year for one company and over thirty percent for two others. If these three firms were eliminated from the sample, the average return on equity over the four-year period would improve from 2.55 percent to 8.13 percent.

should be recalled that holding company profits from insurance operations were substantial, probably eliminating any need to find risk-reducing benefits of diversification. The remaining nonbank activities apparently offered Fifth District firms some degree of reduced risk through diversification, at least over the limited period under examination. Leasing and sales finance activities exhibited either low negative or positive correlation with banking, depending on which profit ratio was analyzed. Factoring and data processing subsidiaries realized rates of return on assets and equity that were correlated negatively with banking—suggesting reduced variability of profits for Fifth District holding companies that combined these activities with banking. A note of caution should be injected into the interpretation of these results. Correlation coefficients estimated from industry (or company) averages using only a few years data must be considered tentative and cannot be relied upon as strong supporting evidence. Too few data observations are utilized for the estimates to achieve statistical significance.

To increase the number of observations used in the calculation of correlation coefficients between banking and each nonbanking activity, an effort was made to pool the cross-section and time-series data included in the analysis [6]. Relevant statistical tests (F-tests) revealed that this technique was only appropriate in the estimates involving the consumer finance and leasing subsidiaries. The correlation coefficients estimated using the pooled income to equity ratios for these two activities were $+0.042$ and $+0.278$, respectively. The estimated correlation co-

efficient between banking and consumer finance affiliates was greatly reduced using this technique while that between banking and leasing was slightly increased.

Summary In summary, nearly five percent of the total assets of Fifth District holding companies are held in nonbank subsidiaries. Lending operations such as mortgage banking, finance companies, leasing, and factoring constitute the bulk of this activity, but many District firms also operate data processing and credit insurance affiliates. With the exception of insurance operations, rates of return on equity investment in these nonbank subsidiaries have not matched those generated from bank affiliates in recent years. This result reflects the lower equity capital to assets ratios that banks are enabled to maintain due to their deposit powers. Rates of return on total assets, in contrast, have favored nonbank operations.

Lower (average) rates of return on equity investment do not necessarily imply that holding company diversification into nonbank areas has adversely affected bank holding company performance. Economic theory and recent experience suggests that average rates of return can be misleading. Basic economic principles show that total profits can be increased by investing in nonbank areas with lower *average* rates of return than banking—provided nonbank investments yield higher *marginal* returns than the banking alternative. Also, preliminary evidence suggests that some nonbank activities of bank holding companies may have contributed to reducing the variability of the consolidated firms' profit streams.

GLOSSARY OF NONBANK ACTIVITIES

Commercial Finance Companies providing financing of business accounts receivables and of sales of commercial, industrial, and farm equipment.

Consumer Finance Companies making direct cash loans on an instalment basis to individuals.

Data Processing Companies providing computer software services and data processing consisting of the preparation of reports from data supplied by the customer. Includes companies providing services solely for the internal operations of the bank holding company system as well as for the general public.

Factoring Companies engaged in factoring and rediscounting of accounts receivable, commercial paper, and instalment notes.

Insurance Companies providing insurance agent or broker services for their parent company or any subsidiary; providing insurance that is directly re-

lated to an extension of credit or that is provided solely for the convenience of the purchaser; acting as insurance underwriter directly or as reinsurer for credit accident and health insurance directly related to an extension of credit by the holding company system.

Leasing Companies engaged in the direct leasing of property and equipment to the general public or to other affiliates within the same holding company.

Mortgage Banking Companies originating and servicing loans secured by real estate or providing financing secured by real estate for construction projects.

Sales Finance Companies purchasing instalment paper which arises from retail sales of passenger automobiles, mobile homes, other consumer goods, or expenditures for home improvements.

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ON FISCAL RESPONSIBILITY*

James Parthemos

I gather that the general theme of your proceedings this year is a thing called "fiscal responsibility" and that I'm expected to say something about what constitutes "fiscally responsible" behavior on the part of the Federal Reserve System. This is a subject which I can tackle with some relish, since I have some pretty strong convictions about it.

As a beginner, let me try to pin down a fairly precise definition of the term "fiscal responsibility." This is necessary, I think, because the term tends to be interpreted in different ways by different groups, depending not only on the context but also on the prejudices of the interpreter. As accountants you are concerned chiefly with fiscal responsibility at the individual firm or program level. The term carries an important dollars-and-cents connotation for you and you are, by training, highly sensitive to the unhappy results of lapses from this kind of responsibility. That attitude would serve us well if it could be extended into the public policy area, and sometimes I think it might be a good idea if some training in accounting were required of all office holders in this country.

It's in the area of public policy, unfortunately, that we have different and, too frequently, conflicting notions of what constitutes fiscal responsibility. And these differences are not confined to the politicians. They apply as well to the large group of professional economists who concern themselves with public policy issues. It's clear, I think, that "fiscal responsibility" would mean one thing to Milton Friedman and quite another to John Kenneth Galbraith; one thing to George McGovern and quite another to, say, Strom Thurmond. At one end of some ideological spectrum the term connotes tight government budgets, without deficits, and with a restrictive view of the appropriate functions of government. At the other, it usually reflects a view that fears of high levels of government spending and government deficits should not be allowed to impede government efforts to solve a broad range of social and economic problems so long as the deficits do not exceed a relatively small fraction of GNP. The basic difference

here, it should be noted, is one regarding the appropriate role of government and, in effect, pits a dollars-and-cents notion of fiscal responsibility *in* government against some loosely defined notion of social responsibility *of* government that transcends dollars-and-cents considerations.

But these are the extremes and serve mainly to point up my rather strong impression that the term "fiscal responsibility" has tended to become a political buzz word with relatively little substantive meaning. It is tossed around by both so-called conservatives and so-called liberals, both left wing Democrats and right wing Republicans, with all sides using it as a sort of shibboleth to support their respective positions and to cajole their respective constituents. We all like to think we are "fiscally responsible," much as we like to think we are morally upright. And we're all tempted to think that those who disagree with us are "fiscally irresponsible" just as we're tempted to believe that those who don't share our moral values may be of dubious morality.

To avoid difficulties that we get into by using terms so loosely, I'd like to offer you a more specific definition of fiscal responsibility in public policy, one that we can establish a concrete criterion for judging. To do this, it might be useful to make a distinction between government policy at the Federal level and that at the level of state and local government. This distinction is important, I think, not only because Federal policies are more pervasive in their immediate effects but also because Federal policies can have important direct and indirect credit and monetary effects that are not present in state and local government policies.

In any case, let me focus for the moment on policy at the Federal level. Here my criterion for judging the fiscal responsibility or irresponsibility of government policies would be their effects on the value and the integrity of the dollar, in both its domestic and its international uses. Policies that take account of the broad social advantages of maintaining a stable value of our currency are, in my view, fiscally sound. Those that assign little or no value to the stability and integrity of our money I would have to call fiscally irresponsible. What I'm saying here is that policies that promote inflation, or even countenance

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its persistence, are irresponsible in the sense that they are bound to eventuate in hardship for substantial groups in our society or for virtually all groups. At worst they can undermine the bases not only of our economic system but the foundations of our political and social institutions, including our position of political and economic leadership in the free world. But, to emphasize here, the important point is the crucial significance of the value and the integrity of the dollar as the criterion for judging fiscal responsibility.

The remainder of my remarks will be devoted primarily to fiscal responsibility at the level of Federal government policies which, I believe, is the area that you're interested in. In any case, it's only at the Federal level that the Federal Reserve System can play any role in promoting fiscal responsibility. But I don't mean to suggest here that the term "fiscal responsibility or irresponsibility" has no meaning at the state and local government level. State and local governments have been known to persist in policies and fiscal practices that quite justifiably deserve to be characterized as irresponsible. We have a number of contemporaneous cases in point. But the payoff for fiscal irresponsibility at these levels—in economic or political or social terms—is neither as extensive nor as dire as that resulting from fiscal irresponsibility at the Federal level. Also, since irresponsible fiscal behavior at the state and local level has no significance for the stability and integrity of our money, the criterion for specifying it must be different from the specifications at the Federal level. At the state and local level the criterion must be related to the sustainability of the debt encumbrance imposed on taxpayers. Clearly the indebtedness of a state or a locality can assume dimensions that impose undue hardships and perhaps also retard economic development through excessive taxes or through defaults that render capital expansion excessively costly or even impossible.

Budgetary Policy and the Value of Money With these background remarks out of the way, let me return now to the theme of fiscal responsibility in public policies at the Federal level. And at this point I'd like to say a few words about deficits in the Federal budget, which many people seem to equate with fiscal irresponsibility. You will note first that a Federal deficit does not *necessarily* represent fiscal irresponsibility according to my definition of that term. Let me emphasize the word *necessarily*. It is possible for a deficit to be financed in such a way that it does not prejudice the integrity or the stability of the dollar. As a matter of fact, sometimes a deficit

may be quite responsible from the public policy standpoint, although my own conviction is that these times are fewer and further between than a good many of my professional acquaintances believe. In any case, it's clear to me that a deficit can be financed without any significant effects on the supply of money or on its value at home or abroad. All that the government has to do is to go out into the market for loan funds and borrow the necessary money, paying the market price, out of the money that's already in existence. It's only when the government undertakes to finance the deficit out of newly created money that the value and the integrity of the dollar is likely to be affected. If the deficits are large and sustained over long periods, the temptation to finance them with newly created money becomes politically irresistible. The reason for this is that the resulting large government demands on our money markets would drive interest rates up to excessive levels and make credit inordinately expensive for private borrowers, both businesses and households, and for state and local governments. To finesse the public hue and cry that would result, the government is highly likely to take what it views as the easy way out and to follow a course that results in the creation of a large amount of new money.

But it usually turns out that this is really not the easy way out. It is only a temporary expedient and, in effect, simply a means of postponing for a time the problem of rising interest rates. As the new money works its way through the economy, prices start rising; that is, inflation sets in. And as inflation gathers steam, two things follow that inevitably push interest rates up. First, higher prices produce an increase in credit demands on the part of businesses, households, and state and local governments. That is easy to see if you consider what happens to the demand for mortgage credit when houses that have been selling for \$35,000 go up to say \$45,000. The buyer now has to borrow \$10,000 more than was necessary before the price increase. This has general application not only to home buyers but also to consumers in general, to businesses, and to governments, all of whom finance a considerable part of their current purchases with borrowed money. The second thing that happens is that suppliers of credit become more reluctant to lend their money at current interest rates. This is because the rising prices mean a steady cheapening of the dollar and lenders know that they will be repaid in dollars that are less valuable in real terms than the dollars they lend. Hence they will demand a premium on their money sufficient to compensate for this cheapening of the dollar.

So with credit demands up and suppliers more reluctant to lend unless they can get a higher return, interest rates quite naturally rise. You can fight this rise for a time by creating more and more new money, but this becomes like the proverbial dog chasing its tail. More analogously, it's like putting yourself on something like "speed" because the more new money you create, the greater the necessity for creating even more.

International Complications Over the past dozen or more years, with the increasing financial integration of the world's major economies, inflation has tended to spawn a new and serious financial complication. The cheapening of the dollar at home has a counterpart in the international exchanges, where the dollar is traded against foreign currencies. We're in a situation now where a cheapening of the dollar at home almost inevitably leads to a cheapening of the dollar abroad. I say "almost" because whether or not the dollar declines in value against other currencies of the world depends on whether inflation over here is proceeding at a pace more rapid than that in other major countries. If all the countries of the world were equally irresponsible fiscally, value relationships among the world's currencies would be unaffected. But if we are more fiscally irresponsible than other countries, then you can expect the value of the dollar in terms of other countries to decline. This is, in fact, what has been happening over the past 18 months, and that should tell us something.

Any sustained decline in the foreign value of the dollar can have serious implications not only for the U. S. economy but also for the economies of the other major countries of the world. Large amounts of dollars are held by foreign monetary authorities as reserves, by central banks and foreign banks, by multinational firms domiciled both here and abroad, and by wealthy individuals. A decline in the value of the dollar means a reduction in the real wealth of these major holders of dollars and this, of course, will have an impact on the economic behavior of these groups. It could, for example, lead to a reduction in their spending, which would mean a corresponding reduction in the level of world trade and investment and hence in economic activity throughout the trading world. Apart from this, any depreciation of the dollar is matched by an increase in the value of other key foreign currencies and this raises the dollar prices of foreign goods. This has important implications both for our economy and foreign economies. Since it raises the prices of our imports it aggravates our own rate of inflation. At the same time it tends

to reduce the worldwide demand for the goods of other important countries, like Germany and Japan, and makes problems for them. This kind of situation promotes political attitudes that make for a proliferation of trade barriers among the trading nations of the world and this too tends to reduce the volume of world trade to the detriment of all countries. It is for reasons like this that we cannot reasonably expect to maintain a position of economic and political leadership in the world in the face of a sustained and progressive decline in the value of the dollar.

Role of the Federal Reserve Now I've gotten this far and I've yet to say anything at all about where the Federal Reserve System fits into this picture. The Federal Reserve, you must know, is our central bank. It has the power and the authority to create and destroy money. More correctly, it has the power and authority to vary the rate at which new money is being created at any given time. It should follow from this that if too much new money is being created and inflation is resulting the Federal Reserve is, somehow, to blame—or, at least, that it is implicated in the crime. And, as a matter of fact, there are people, some of them highly respected professional experts, who lay the blame directly at our door.

Now I'm not here to apologize for the Federal Reserve on this particular score. But I think we ought to be careful to give the Fed a fair trial. And to do this it's first necessary to appreciate some unique features of our central banking arrangements. The Federal Reserve differs in some important respects from other central banks that have the power to control money and credit. For the most part, the difference grows out of the greater degree of political democracy that exists in this country compared with the other major countries of the world. This can be seen, I think, when we consider the position of the Federal Reserve in our political system.

The Constitution of the U. S. vests the monetary authority in the Congress of the U. S., i.e., in the elected representatives of the people. Monetary management, of course, is a specialized art that can hardly be carried out by a body of 535 representatives. So, through experience that was sometimes quite painful, Congress early in this century decided to delegate the task of monetary management to a central bank, i.e., to the Federal Reserve. But it has taken pains to insure that the Fed be accountable to Congress and it is clear that our money cannot be managed without regard to the Congressional will.

What I'm saying here, of course, is that despite

the talk of an "independent Federal Reserve," the Fed is in fact not independent. Or, if it is independent, it is in a quite unique sense of that term. We are certainly not independent of Congress. If Congress passed a law requiring us to inflate the currency at a 10 percent per year rate, it is difficult to see how we would do otherwise. Also it is not at all clear that we are entirely independent of the executive branch of government, i.e., of the President and the Treasury. The Federal Reserve Act and its many amendments give us some specific duties to perform for the Administration at its command and at its pleasure. So whether we have independent authority to manage money and credit on the basis of our own judgment and in disregard of Congress and the Administration is questionable at best.

Now this brings me to the key question that has to be answered in evaluating the role of the Federal Reserve in this thing that we call "fiscal responsibility" and which I have linked to the necessity of maintaining the stability and the integrity of the dollar. I have noted that large and persistent deficits in the Federal budget, if financed through the creation of new money, must inevitably lead to inflation and to a cheapening of the dollar both at home and abroad. I have also noted that the Federal Reserve, as our central bank, manages the actual operations through which new money is created. Finally, I emphasized that the Fed is accountable to Congress and not altogether independent of the executive. Now the question is this: In the face of large and persistent Federal deficits that exert strong upward pressures on interest rates, how should the Federal Reserve react?

Basically, in such a situation, there are two courses of action open to the Fed, both of which involve risks that could prove serious from the standpoint of the economy's behavior. First, we could ignore the deficits and let the resulting pressures on interest rates show through directly and immediately in our money and credit markets. This would make money and credit significantly more expensive for private borrowers and shift resources directly from the private sector to the public sector. Private businesses would be hurt and the level of activity in the private sector would probably suffer since less capital than otherwise would be available to that sector. To the extent that the private sector makes more efficient use of resources than government does, the overall performance of the economy would suffer. And of course with the rigidities that we have in our economy and in our financial markets, there's always a good chance that a strong upward movement in interest rates

could do serious damage to a key sector of the economy, like construction, and through such an effect precipitate a business recession. In any case, this particular course of action would not be accompanied by any significant degree of inflation and may well strengthen rather than prejudice the value of the dollar abroad.

The second course of action would involve resisting the interest rate pressures resulting from the deficits by creating new money. If the deficits were large and we undertook to finance them entirely through the creation of new money, the amount of money in the hands of the spending public would grow at a rapid rate. At some fairly early stage, depending on the rate of resources use at the time the deficits begin, prices would begin to rise. As I noted earlier, this in itself would produce strong upward pressures on interest rates, which would reinforce the pressures generated by continuing deficits. So, in the face of continuing large deficits, efforts to resist rising interest rates through new money creation will succeed only in feeding inflation without moderating upward pressures on interest rates. As a matter of fact interest rates would probably continue to rise as the inflation progressed. And, as I noted, to the extent that our inflation outdistanced that in other countries, our dollar would be cheapened in the foreign exchanges and this too would exacerbate both our inflation and our interest rate problems. So it's clear that any sustained program undertaken to offset the interest rate effects of large, persisting Federal deficits through monetary expansion can lead to no good end. It will inevitably set off a train of economic and financial developments that will lead to some kind of economic impasse, a business slump at best or a major financial crisis at worst.

The moral of the story here is that large, continuing deficits put us on the horns of a painful dilemma. We either have to accept, without resistance, a sharp rise in interest rates that shrinks the private sector and risks a business recession. Or, alternatively, we can launch a program of monetary expansion to resist the interest rate pressures, knowing that, if the deficits continue, the program will not only be futile but will also increase the risks of a serious recession. The fact of the matter is that when large Federal deficits persist over a long period, as they have over the past ten years, the Federal Reserve has no good options.

My own feeling is that the least bad option is to ignore the deficits and let the government, like everyone else, pay the going market price for the funds it needs to borrow. I think we come out much better

when we gear monetary growth to the steadily growing money and credit requirements of the private sector, without regard to the borrowing needs of the government except in periods of war or of grave national emergency. But, as either a legal or as a practical matter, it is not clear that we have the authority to follow such a course. The law, as I said earlier, saddles us with some responsibilities to the Treasury in its financing operations. Moreover, Congressmen, sensitive to the complaints of constituents who depend on borrowed money, don't like to see interest rates rise, even when the increases are the inevitable outcome of budgetary and tax legislation that they themselves are responsible for. So in the kind of situation I have been describing all the pressures on us are in the direction of resisting the rate increases through monetary expansion.

These pressures are, of course, of a political nature. And here, I think, it's appropriate to raise the question of whether the Fed should or should not knuckle under to these pressures. It's easy to say that we should not if, in our judgment, knuckling under is not in the public interest; that we should be "courageous." Perhaps we should. But we should keep in mind the point I made about the so-called "independence" of the Fed. We are a creature of, and accountable to, Congress as a Constitutional matter. Can we really afford to substitute our own judgment of the public interest for the Congressional will which, after all, is supposed to be, in our form of democracy, a reflection of the will of the people? Is it appropriate for us to do so? These are the kinds of questions that have to be answered in assessing the Fed's role in promoting fiscal responsibility in our society.

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